DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 00-0126
Gross Income Tax
For Tax Years 1995 through 1997

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ISSUE

Gross Income Tax—Construction Allowances

Authority: *First National Bank of Richmond v. Turner*, 154 Ind. 456, 461-62, 57 N.E. 110, 112-113 (1990); *Bailey v. Clark*, 88 U.S. 284, 22 L.Ed. 651 (1874); *Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228, 238 (Ind.App. 1984); *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583, 70 S.Ct. 820 (1950); *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 63 S.Ct. 902 (1943); *United States v. Chicago, Burlington & Quincy R. Co.*, 412 U.S. 401, 93 S.Ct. 2169 (1973)
IC 6-2.1-1-2(c)(14); IC 6-2.1-2-2(a)
45 IAC 1-1-58; 45 IAC 1.1-6-5

Taxpayer protests the assessment of Indiana gross income tax on the amount taxpayer received from the landlord/developer as a construction allowance.

STATEMENT OF FACTS

Taxpayer is an operator of retail bookstores. As part of its business, taxpayer enters into lease agreements with landlords/developers to lease building space for its stores. Although the landlord/developer owns the building, taxpayer has an exclusive right to the building space during the term of the lease.

Upon taking possession of the space (which is generally delivered to taxpayer as a "vanilla box", a building shell, or a previously occupied space), taxpayer bears the responsibility of completing or improving the store interior, including fixtures, furniture and equipment. As a part of the lease agreement, taxpayer negotiates with the landlord/developer to receive a construction allowance as reimbursement for part or all of

its construction costs. Landlords/developers are willing to provide construction allowances because they induce would-be tenants to locate within the shopping center. Upon termination of the lease agreement, taxpayer has no right to the improvements to the leased premises. The improvements are the property of the landlord/developer.

After a routine audit for the years in question, the Department of Revenue issued a notice of proposed assessments for gross income tax and interest on the construction allowance taxpayer received from the landlord/developer as reimbursement for construction costs taxpayer incurred in completing and improving the interior space of an Indiana location. Taxpayer excluded the construction allowance from its taxable gross income.

Gross Income Tax—Construction Allowances

DISCUSSION

In dispute is taxpayer's exclusion of the construction allowance from its taxable gross income. Indiana's Gross Income Tax encompasses most receipts of income. Pursuant to IC 6-2.1-2-2(a), "[a]n income tax, known as the gross income tax, is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana . . ." Except as expressly provided in IC 6-2.1 et. seq., gross income means all of the gross receipts a taxpayer receives. However, some exceptions do exist.

Taxpayers are not subject to Indiana's gross income tax on the income they receive as contribution to capital. 45 IAC 1-1-58. More specifically, under IC 6-2.1-1-2(c), "[t]he term 'gross income' does not include: . . . (14) the receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to the capital thereof; . . ." IC 6-2.1-1-2(c)(14).

In Indiana, the term "capital" is defined by our case law as follows: "When used with respect to the property of a corporation or association the term has a settled meaning; it applies only to the property or means contributed by the stockholders as the fund or basis for the business or enterprise for which the corporation or association was formed . . ." *First National Bank of Richmond v. Turner*, 154 Ind. 456, 461-62, 57 N.E. 110, 112-113 (1990) (citing *Bailey v. Clark*, 88 U.S. 284, 22 L.Ed. 651 (1874)). This definition has not been altered in Indiana case law to negate that capital must be contributed by stockholders. *See Hamilton Airport Advertising v. Hamilton*, 462 N.E.2d 228, 238 (Ind.App. 1984). The common meaning of "capital contribution" is stated in Black's Law Dictionary 7th Edition (1999) as: ". . . 1. Cash, property, or services contributed by partners to a partnership. 2. Funds made available by a shareholder, usu. without an increase in stock holdings."

Taxpayer's landlord/developer is not a partner or shareholder of taxpayer. The construction allowance is remitted to taxpayer by landlord/developer as an incentive to

taxpayer to locate within landlord/developer's shopping center. As such, the purpose for which the allowance is remitted to taxpayer demonstrates that a genuine question can be raised as to whether the allowance falls outside of the scope of the plain and ordinary meaning of IC 6-2.1-1-2(c)(14) and 45 IAC 1-1-58 with respect to a contribution to capital. The question we now address is whether the construction allowance received by taxpayer from the landlord/developer was a contribution to taxpayer's capital within the purview of IC 6-2.1-1-2(c)(14) and 45 IAC 1-1-58.

The argument that non-partners and non-shareholders may contribute capital to a corporation is supported by *Brown Shoe Co., Inc. v. Commissioner*, 339 U.S. 583, 70 S.Ct. 820 (1950). In *Brown Shoe*, local communities provided cash contributions as incentives to a manufacturer to locate in their towns. The Court held that the cash contributions were "'contributions to capital' within the meaning of [1939 Internal Revenue Code] Sec. 113(a)(8)(B)", [(now Sec. 362(a))] and were therefore entitled to be depreciated. *Id*. at 589, 70 S.Ct. at 825; *see also* I.R.C. Sec. 362(c). The holding in *Brown Shoe* which recognized that non-shareholders could make contributions to capital was narrowed by the Court to those instances where there are neither customers nor payments for services. *Brown Shoe*, 339 U.S. at 589, 70 S.Ct. at 824. The Court in *Brown Shoe* stated that:

> The contributions to petitioner were provided by citizens of the respective communities who neither sought nor could have anticipated any direct service or recompense whatever, their only expectation being that such contributions might prove advantageous to the community at large. Under those circumstances, the transfers manifested a definite purpose to enlarge the working capital of the company. *Id*. at 591, 70 S.Ct. at 824.

In reaching its decision, the Court in *Brown Shoe* distinguished the case before it from the earlier case of *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 63 S.Ct. 902 (1943). In so doing, the Court stated that:

> [The *Detroit Edison*] decision denied inclusion in the base for depreciation of electric power lines the amount of payments received by the electric company for construction of the line extensions to the premises of applicants for service. It was held that to the extent of such payments the electric lines did not have cost to the taxpayer, and that such payments were neither gifts nor contributions to the taxpayer's capital . . . . *Brown Shoe*, 339 U.S. at 591, 70 S.Ct. at 824.

In *Detroit Edison*, "[t]he payments were to the customer the price of the service [provided by taxpayer.]" *Detroit Edison*, 319 U.S. at 103, 63 S.Ct. at 904. Therefore, the Court concluded, "it overtaxes imagination to regard the farmers and other customers who furnished these funds as makers either of donations or contributions to the Company." *Id*. at 102, 63 S.Ct. at 904.

The Court in *United States v. Chicago, Burlington & Quincy R. Co.*, 412 U.S. 401, 93 S.Ct. 2169 (1973), summarizes the distinctions made by *Detroit Edison* and *Brown Shoe* with regard to whether non-shareholders can remit monies to corporations as contributions to capital.

> Where the facts were such that the transferors could not be regarded as having intended to make contributions to the corporation, as in *Detroit Edison*, the assets transferred were not depreciable. But where the transfers were made with the purpose, not of receiving direct service or recompense, but only of obtaining advantage for the general community, as in *Brown Shoe*, the result was a contribution to capital.

Chicago, Burlington, 412 U.S. at 411, 93 S.Ct. at 2175.

> We can distill from these two cases [*Detroit Edison* and *Brown Shoe*] some of the characteristics of a non-shareholder contributor to capital under the Internal Revenue Codes. It certainly must become a permanent part of the transferee's working capital structure. It may not be compensation, such as a direct payment for a specific, quantifiable service provided for the transferor by the transferee. It must be bargained for. The asset transferred foreseeably must result in benefit to the transferee in an amount commensurate with its value. And the asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Id. at 413, 93 S.Ct. at 2176.

By this measure, the assets with which this case is concerned clearly qualify as contributions to capital. Taxpayer negotiated and entered into a lease agreement with the landlord/developer of the shopping center for the lease of building space. As part of the agreement, landlord/developer agreed to provide taxpayer with a construction allowance. Once the space was delivered to taxpayer, taxpayer completed and improved the interior store space. Taxpayer could not open its doors to the public and begin generating income until the improvements were made to the space. Upon completion of the interior of the space, taxpayer received the construction allowance from landlord/developer as reimbursement for construction costs taxpayer incurred in competing and improving the interior store space.

Since in this case there are neither customers nor payments for service, we infer a different purpose in the transactions between taxpayer and the landlord/developer than the purpose found by the Court in *Detroit Edison*. The promise of a construction allowance was in no way a payment for any direct service or recompense. The landlord/developer's offer to provide a construction allowance to taxpayer was made with the expectation that taxpayer would agree to locate its store in the landlord/developer's shopping center. The improvements taxpayer made to the space would have been made whether or not landlord/developer agreed to provide a construction allowance. In short,

the landlord/developer's construction allowance falls within the practical working definition of "contributions to capital" that was recognized by the Court in *Brown Shoe*, and not within the narrow exception of payments for services that the Court found significant in *Detroit Edison*. We, therefore, find that the construction allowance received by taxpayer from the landlord/developer was a contribution to taxpayer's capital within the purview of IC 6-2.1-1-2(c)(14) and 45 IAC 1-1-58, and is, thus, excludable from gross income.[1]

FINDING

Taxpayer's protest is sustained.

HLS/PE/MR -012906

[1] Although the regulation promulgated by the Department in effect during the tax period 1995-1997 (*i.e.*, 45 IAC 1-1-58) did not contain examples, the capital contribution exception is explained in the most recently promulgated regulations concerning capital contributions, *i.e.*, 45 IAC 1.1-6-5, which states in relevant part that:

> . . . [A] contribution to the capital of a taxpayer, whether or not from the sale of an interest in such taxpayer is not included in the gross income of such taxpayer.
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> . . .
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> (c) To qualify as a contribution to capital, it must be shown that the principal benefit derived from a contribution is a capital improvement, a strengthening of the capital structure of the taxpayer, or an enhancement of the contributor's ownership interest. The following are examples of a contribution to capital:
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> . . .
>
> (3) A contribution by a shopping center developer of land and building costs to a corporation to attract it as the anchor tenant for a shopping center.

45 IAC 1.1-6-5. The example of a non-taxable capital contribution, set forth in IAC 1.1-6-5, is similar to the construction allowance contribution received by taxpayer.